



**December 12, 2005**

**AGENDA ITEM 11**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Follow Up to Board Workshop on Expanding Investment Opportunities through Diversity
- II. PROGRAM:** CalPERS Total Fund
- III. RECOMMENDATION:** Approve staff recommendation to supplement and expand upon CalPERS Investment Office existing diversity-related efforts, by taking the following steps to develop and implement an investment approach consistent with fiduciary principles that seeks to take advantage of the ideas and skills of all of the participants in the investment industry:
1. Issuing a Request for Proposal to establish a spring-fed pool of consultant experts on diversity in the investment industry;
  2. Completing the emerging financial service provider reference guide; and
  3. Hosting a conference on Expanding Investment Opportunities through Emerging Markets and Managers.
- IV. ANALYSIS:**

**Executive Summary**

On November 15, 2005, the Investment Office presented to the CalPERS Board a workshop on Expanding Investment Opportunities through Diversity. Based on input received through preparation for the workshop, as well as on information presented at the workshop, the Investment Office recommends that the Investment Committee authorize staff to supplement and expand upon its

existing diversity-related efforts, by taking specific steps to develop and implement an investment approach, consistent with fiduciary principles, that seeks to take advantage of the ideas and skills of all of the participants in the investment industry.

This approach would apply across all asset classes and would be designed to ensure that CalPERS, as an institutional investor, is poised to fully engage the marketplace and take advantage of opportunities created as a result of fundamental demographic shifts occurring at the state and national levels. In addition, diversification among our provider base will provide a sustainable competitive edge and ensure that CalPERS continues to be on the cutting edge of innovation in the investment arena.

### **Background – CalPERS Ongoing Diversity-Related Activities**

As the nation's largest public pension fund and an organization with a global impact, CalPERS recognizes that diversity is an important business issue. The issue of diversity has been embraced in CalPERS strategic goals and enterprise wide operations for many years.

In 2000,<sup>1</sup> the CalPERS Board formally adopted a diversity policy recognizing that a positive work environment is cultivated through diversity awareness. This policy expressly provides that "CalPERS will endeavor to foster an environment that benefits from diversity at all levels, values individual differences and enables all employees to develop and contribute to their full potential." This diversity policy is further embedded in CalPERS core values. In 2004, CalPERS created a Diversity Outreach Program and hired a Diversity Coordinator to oversee this program. Finally, in the recently adopted CalPERS 2005 Strategic Plan Goals, the Board again highlighted the importance of diversity as a fundamental business philosophy.

The CalPERS Investment Office currently has ongoing efforts, in all asset classes, in the area of diversity. These efforts have generally fallen within three categories: programs that seek to take advantage of investment opportunities within emerging markets; programs that seek to leverage the skills and talents of emerging managers; and efforts to expand outreach and networking. The Investment Office regularly reports on these various programs and will therefore simply itemize them briefly here:

- **Emerging Markets**
  - The California Initiative Program, established in 2001, currently has approximately \$475 million committed to ten private equity firms focused on investment opportunities in California underserved markets.

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<sup>1</sup> Even prior to adoption in 2000 of this formal policy, the CalPERS Board in 1998 created the CalPERS Business Connection to help promote diversity in its contracts and procurement of services.

- The California Urban Real Estate (CURE) Program, established in 1997, had over \$760 million invested as of June 30, 2005; the Program emphasizes urban redevelopment, especially residential and mixed use, with a California focus.
- In total, CalPERS investments and commitments to underserved areas of California totaled \$4.8 billion as of June 30, 2005. This included investments in the real estate, private equity, and fixed income asset classes.
- Emerging Managers and Brokers
  - The Manager Development Program (MDP), implemented in May 2000 to further investment in small and emerging firms, has as of September 30, 2005, \$2.9 billion allocated among 14 firms, through two strategic partners.
  - The Manager Development Program II (MDP II) established a spring fed pool in June 2005, with five advisors appointed to the pool; funding is expected to occur in the first quarter of 2006.
  - Investment Office staff continues to conduct outreach efforts and to increase its transactional activity with emerging brokerage firms in both the fixed income and equity programs.
- Outreach
  - CalPERS engages in proactive outreach through participation in conferences, as well as on boards and advisory committees, by Trustees, Executive Staff, and Investment Office professionals.
  - CalPERS has contracted, in collaboration with the California State Teachers' Retirement System (CalSTRS) for the development of a leading edge and comprehensive reference guide/database of emerging financial service providers. Information to be used in this database will be obtained through a detailed survey that will be available through CalPERS and CalSTRS websites and will be widely advertised. The survey parameters have been developed in consultation with CalPERS Investment Office staff.
  - CalPERS submits twice annually a report to the Legislature on the efforts related to diversity. Copies of these reports have been provided, concurrent with submission to the Legislature, to the Investment Committee.

### **November 2005 Workshop**

Recently, and in light of fundamental demographic shifts at the statewide as well as national levels, the issue of diversity as it relates specifically to public pension fund investment programs, and to CalPERS in particular, has been a matter of

increased interest for the investment community, various constituent groups, and the State Legislature.

Accordingly, on November 15, 2005, the Investment Office presented to the Board a workshop titled "Expanding Investment Opportunities through Diversity." (See agenda at Attachment A.) The workshop was well attended. In addition to full attendance by the CalPERS Board, the audience consisted of a substantial number of CalPERS Executive and Investment Office staff, existing investment partners and managers, and other members of the financial service provider community.

The purpose of the workshop was to provide an educational forum on the business issue of diversity within the investment industry, and to lay the groundwork for establishing a work plan to supplement the efforts CalPERS and the Investment Office have already taken in this arena.

In preparation for the workshop CalPERS, through its consultants, conducted a survey to determine stakeholder perceptions about the value of increasing the diversification of CalPERS financial service provider base. This survey consisted of approximately forty one-hour interviews with CalPERS trustees and senior Investment Office staff, investment managers and consultants, advocacy groups, and public pension plan representatives. The survey focused on several issues, which are outlined below along with a brief summary of the survey findings, as presented at the workshop.<sup>2</sup>

- Defining the issue. Interviewees were consistent in their view that the issue of diversity as it relates to the investment industry must be approached as a business proposition. Based on the survey, the following working definition of diversity, as it relates to the investment industry, was established:

***"An investment approach consistent with fiduciary principles that seeks to take advantage of the ideas and skills of all of the participants in the investment industry."***

Several studies have been conducted on the challenges and opportunities faced by emerging investment firms and managers, including some that have reviewed the investment performance of these managers. A summary of this research was included in the workshop materials. (Attachment B.)

- Challenges. The survey identified challenges faced generally by pension funds with respect to the issue of diversity in investments, including: lack of commitment to change; lack of recognition of the growing opportunities in emerging markets; and diversification "for the wrong reasons."

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<sup>2</sup>The full presentation of the survey findings was included in the November 14, 2005 workshop materials.

- Best practices. Survey participants identified several “best practices.” These included: demonstrated leadership and commitment of trustees and investment professionals; proactively managing and constructively engaging consultant and investment management firms; using fund of fund/manager of manager structures; ensuring that emerging firms are treated with the same patience as established firms; and supporting education programs that increase the pool of diverse talent. In addition, best practices include finding ways to creatively address existing constraints, including for example the cumbersome RFP and contracting process.
- Benefits and disadvantages of addressing this issue. The discussion of benefits focused on diversification as a potential for sources of increased investment opportunity. The effort to engage the marketplace and take advantage of opportunities created as a result of fundamental demographic shifts was described as the “pure diversification play.” In addition, the diversification of the “inputs” (i.e., the investment staff, as well as the base of investment managers and advisors) was described as “diversification as a driver of innovation.”

Disadvantages included the possibility that efforts to promote diversity could be misunderstood to be a “social agenda” rather than a business strategy. In addition, it was noted that the development of new programs generally requires start-up costs.

- Implementation challenges. The survey identified several challenges that may be faced by public pension funds seeking to implement a diversity strategy. These include: determining the appropriate internal policy; establishing clear measures of success and related performance-based compensation metrics; providing the necessary internal support (e.g., research and data, training, monitoring and reporting processes, recognition of progress); and providing clear direction to consultants and advisors.

Finally, it was noted that, because of CalPERS size and general leadership role, interviewees tended to have high expectations of CalPERS. A related cautionary note was issued: “take the time to get this right.”

The workshop also included presentations by experts in the investment industry. These experts included plan sponsors as well as investment managers (both CalPERS partners and those who are not CalPERS partners). The expert presentations reinforced the themes identified through the survey.

### **Recommendation/Next Steps**

Staff recommends that CalPERS supplement and expand upon its ongoing efforts on this issue, by developing and implementing an investment approach, consistent with fiduciary principles, that seeks to take advantage of all skills and ideas in the investment industry.

This approach would apply across all asset classes and would be designed to ensure that CalPERS, as an institutional investor, is poised to fully engage the marketplace and take advantage of opportunities created as a result of fundamental demographic shifts occurring at the state and national levels. In addition, diversification among our provider base will provide a sustainable competitive edge and ensure that CalPERS continues to be on the cutting edge of innovation in the investment arena.

In developing and implementing this approach, we believe it is critical that certain key following components be considered. Specifically, the ultimate approach should:

- Be embodied in CalPERS Board policy;
- Address issues of accountability – both internally and externally; and
- Include clear methodology and metrics for measuring success.

To further this recommendation, staff proposes the following three steps:

#### **1. Issue a Request for Proposal (RFP) for Consultant Services**

Staff recommends the use of experts to review CalPERS existing policies and practices, identify best practices and policies that are most pertinent to and appropriate for CalPERS, and – as appropriate – assist in implementation of these practices and policies. To accomplish this, staff recommends issuance of a Request for Proposal (RFP) to identify consultants with expertise on the issue of diversity within the investment industry. Selected experts would constitute a spring fed pool.

Staff is ready to issue the RFP, and it is anticipated that the spring fed pool will be established in March or April 2005, at which time staff will report to the Investment Committee on the establishment of the pool.

#### **2. Complete the Emerging Financial Service Provider Reference Guide/DataBase**

As explained above, this project is already underway. Upon completion of this groundbreaking effort, we will have available a comprehensive database of emerging financial service providers. This guide will provide a detailed view of the universe of emerging and developing financial service provider firms – including the capabilities and potential offered by these firms. The analysis we

will be able to derive from this database will assist in our effort to determine further steps that may need to be taken to enhance diversification of our provider and partner base. The database will be a valuable tool to assist the work of the expert consultants described above.

CalPERS is collaborating in this effort with CalSTRS. Upon completion, it is our intent to make this important resource available to other institutional investors throughout the country, which will reinforce California's leadership on this issue.

The survey that will be used to obtain input for the database is currently being developed; we anticipate that it will be released within the next 4-6 weeks. To date, the market has expressed enthusiasm for the project. Although we have yet to formally issue the survey, the consultant has received over 200 phone calls and 120 emails from a wide variety of investment service providers interested in participating in the database.

3. Host a Conference on Expanding Investment Opportunities through Emerging Managers and Markets

To further the dialogue on this important issue, CalPERS will host a conference on April 24-25 in San Jose, California. The conference will frame the issue of diversity within the investment industry as a significant business strategy, and will serve the dual purposes of education and outreach. The conference is designed as a one-day forum (April 25), with a reception on the preceding evening (April 24). We are pleased that our sister system, the California State Teachers' Retirement System (CalSTRS) has agreed to co-host the conference and has further agreed to equally share in the pertinent costs and labor.

Staff is currently developing the specific objectives and themes for the conference, and will keep the Committee updated on its progress.

#### **IV. Strategic Goals**

Goal 1, Exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems; Goal II, Foster a work environment that values quality, respect, diversity, integrity, openness, communication, and accountability and Goal IX, Achieve long-term, sustainable, risk adjusted returns.

#### **V. Results / Costs**

Implementation of these recommendations will further the objective of diversification of CalPERS base of investment service providers, to ensure that we are taking advantage of all skills, ideas, and opportunities in the marketplace. Consultant costs have not yet been determined, but it is anticipated that these costs will be outweighed in the long-term by the advantages rendered to the investment program. With respect to the conference, we anticipate that registration fees will cover most if not all of the cost of the conference.

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